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Cover Story: Rent

It can mean a new source of revenue, but it also can distract builders from their primary mission building and selling the American dream

By John and Sarah Yaussi

When Beazer Homes executives announced in April the launch of a pre-owned homes division, industry response segregated into two camps.

On the one side of the line were those, including a number of Wall Street analysts, who looked askance at the decision, struggling to wrap their heads around why a pure-play home builder, especially one as back on the financial ropes as Beazer, would want to dabble in rehabbing foreclosed homes and turning them into rental units. There was skepticism about the scalability of such an operation, as well as the ultimate benefit to the builder's balance sheet.

In contrast, there were other industry stakeholders who could smell opportunity from the first mention of rental. Several of the industry's biggest players were already tinkering in loosely related side businesses, hoping to make some nice gains out of an ugly market. Both Lennar and Toll Brothers, for example, had ventured into the distressed real estate game, setting up joint ventures to buy huge portfolios of loans backing bad land deals from banks and the federal government. Similarly, a rental business could provide the financially strapped company with a much-needed additional source of steady revenue.

While it remains to be seen whether the new operation benefits Beazer's balance sheet, its creation shows that many of the industry's biggest players will need to do more than just become leaner and more efficient in home building operations to return to profitability. Demand for for-sale housing just isn't there, as the economic downturn has nearly nixed new household formation, a key driver of demand, bringing it to its slowest annual growth rate in more than 40 years. And while the job picture may have marginally improved, the nation's 9.1 percent unemployment rate, budget crisis, and debt downgrade aren't doing much to shore up consumer confidence.

At the same time, it's impossible to ignore the éclat the multifamily business is generating. All the buzz, all the excitement, all the ado, and a lot of the political and cultural compass seem to have renting, not owning, in mind. Most recently, the Obama administration was soliciting ideas on how to turn more than 250,000 foreclosed homes owned by government-backed Fannie Mae and Freddie Mac into rental homes. It may be a cyclical thing. Or not. It may be that demographics' next twist—not only among millennials but possibly also among those who are moving inexorably out of primary careers toward a next phase of life—is to shift housing preference to being freed of the deed.

So, it follows that the traditional for-sale housing business community—which largely built its name and reputation on excelling in the cash-in, cash-out single-family business—should entertain a fairly serious look at how an emerging “rentership society” could be a business opportunity. While most home builders lack some of the critical skill sets in construction, financing, and operations and management necessary to compete with major players like multifamily REITs, there are niches in the rental market that are opening up that could play to a home builder's advantage.

Beazer executives are banking that the shift is here to stay for at least long enough to reap some balance sheet benefit, choosing to up its investment in its new pre-owned home division, turning an in-house $10 million pet project into $20 million off-balance sheet joint venture. Management's got the program on an accelerated plan, with 100 homes in Phoenix and Las Vegas in its rental portfolio.

“While today's difficult new-home sales environment creates challenges for our home building business, it creates sizable opportunities for the pre-owned homes division we launched this spring,” Beazer CEO Allan Merrill said during a recent conference call with stock analysts.

Chances are Beazer isn't going to be alone in its rental venture, even though the sector remains an untraditional prospect for single-family builders in a rental market traditionally dominated by multifamily powerhouses.

THE RISE OF RENTALS

There is the compelling, if yet unanswered, question hanging like a cloud over the for-sale, single-family housing industry: Can the American dream of homeownership be revived?

Estimates for homeownership are that rates will slide down the scale from a current 66 percent, across the 65 percent line, and possibly continue as low as 63 percent or 62 percent, by some forecasts. This dip, whether temporary or otherwise, is reflective of a housing demand universe undergoing structural alteration by virtue of two distinct but connected causes. First, the pendulum on consumer preference has swung from a my-home-is-my-castle attitude toward housing to a decidedly maintenance-and-mortgage-free mentality, as persistent economic uncertainty erodes confidence in a home as a safe investment. Moreover, housing finance economics are decidedly more complicated with less government support.

The combination of these factors adds up to a greater capital flow toward for-rent versus for-sale housing. Consequently, home builders, public and private, are examining both their capital structures and their operational skill sets to determine whether it makes sense for them to diversify into for-rent while the getting's good.

And the getting is definitely good. According to the National Multi Housing Council Apartment Market Conditions survey, which measures velocity in the rental market, it's white hot out there. At press time, the index had a reading of 82; anything higher than 50 means vacancies are falling and/or rents are on the rise. With the prospects for demand, opportunity, investment, development, and construction of rental properties seemingly brightening profoundly, both public and private home building companies are dissecting the for-rent market in search of a revenue opportunity that could be bolted on to their existing business model.

Home builders have long been in search of the Holy Grail of a recurring revenue stream. From pest control to security systems, builders have been experimenting with ancillary businesses that can provide them with revenue stability that the for-sale market's cyclical nature can never offer. And a rental model has long been in the mix. Builders such as KB Home, Shea Homes, Warmington Homes, William Lyon Homes, and others have histories of using some of the cash flow from their home building operations to fund longer-term investment opportunity, sometimes creating commercial real estate, resort, retail, even industrial property development, construction, and management operations to flank their home building companies.

A traditional rental diversification model would create a separate operational and capital unit to develop, build, and derive revenue from multifamily apartment rentals. The separate-but-equal structure reflects just how little carryover in competencies there is from single-family for-sale to multifamily for-rent. The two businesses take different tacks on everything from operations and financing to marketing and customer service. Even having the skill sets to build specific kinds of product can be problematic.

Tom Baum, who heads up The Bozzuto Group's Bozzuto Homes division, has first-hand experience in striking the balance between for-sale and for-rent operations under a single umbrella. Bozzuto's not new to the game, having made the two part of its countercyclical diversification strategy for the better part of two decades. He says at first, Bozzuto management thought that lots of the entitlement, construction, and marketing skills on the apartment side would translate to the single-family business, but fairly early on they learned otherwise.

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“The for-sale business is a completely different business in almost every way. There are different investors, different capital requirements, a whole different mind-set operationally. The for-sale side is customer-centric in a wholly different sense, so that it almost becomes a retail business, where the builder is almost like a manufacturer working more closely with the customer. That's a different mentality than on the apartment side. There are also different types of equity and debt financing, and a whole different revenue model. After a really steep learning curve, we believe you've got to segregate the two businesses entirely,” he says.

He adds: “If any company is actually contemplating going into the for-rent side, it shouldn't be without understanding it's a commitment to go into an entirely different business. We look at our home building side as the cash-generating business. You're not tying up equity for 10 years at a time—at least you hope you're not—and you're achieving turns on your equity quickly. Rental apartments on the other hand, you're working with institutional partners that have much longer-term horizons, seven, 10, even 15 years. That's an investment strategy, not a cash-generating business."

But for those with the skill and the patience to navigate multifamily rental's runway, their wait is often worth it.

Jim Jenkins, a senior vice president for Texas-based master developer Hufflines Communities, sees a dual benefit. In the nearer term, once a part of the so-called "rentier" class, "a builder can finally step back from the treadmill and have some money coming in the door to give you a cushion when the economy turns down."

But longer term, a builder might reap good-sized returns by selling offstable properties to multifamily real estate investors or REITs, earning 5 percent to 8 percent returns on a deal versus today's normal rate of return of just under 1 percent. "Having income property in today's environment gives companies an extraordinary rate of return," Jenkins says.

AN ALTERNATIVE RENTAL REALITY

The lack of visibility in demand for for-sale units; the shift in consumers, housing finance organizations, and real estate investment groups' tastes in favor of rental; and the promise of a steady revenue stream and good returns are pushing builders to wonder if there's not an alternative rental scenario out there that might be able to keep the engines running when for-sale demand plays 'possum. After all, given the nature of the business, builders must develop and build—or perish. Student housing and senior or active-adult rental communities are two developments being kicked around, but the one that seems to be gaining traction among the builder set is the idea of a scalable lease-to-own housing solution that would attract renters with a detached, single-family product and turn them into buyers as the economy and mortgage finance industry complete their correction.

While traditional apartment developers are scurrying to bring more units on-line to fill the housing demand of 25- to 40-year-old single people or couples with no kids, many of America's two-kids-and-a-dog families are looking for alternative rental options. Maybe they've been victims of foreclosure or maybe they are just homeownership-phobic, but whatever their reason for wanting to rent is somewhat at odds with their need for a traditional suburban house with a garage and a backyard rather than a two-bedroom downtown apartment. Moreover, there's an entire cohort of would-be entry-level buyers who want to purchase a home but given today's credit environment cannot access financing, be it because of a lack of down payment funds or blemishes on their credit reports.

And that's arguably something the multifamily powerhouses don't necessarily "get" right now even though demand in that subsegment of the rental market is growing measurably. According to a recent Zelman & Associates analysis of U.S. Census data, not only has the overall number of single-family rental households grown 21 percent from 2005 to 2010, but in places like Arizona, Florida, and Nevada, where markets are drowning in foreclosures and short sales, as many as one in three rental units is a traditional single-family house.

And if there's one thing home builders are experts on, it's American families. They understand family values, needs, dreams, and expectations and have been building product to fit those bills for a long time.

Jonathan Smoke, senior vice president of products and innovation for BIG BUILDER's sister division Hanley Wood Market Intelligence, sees potential for a rent-to-own model. “If I were a builder, I'd be looking at this space as an innovative way to build traditional, single-family, suburban homes.” Besides giving builders volume against which to leverage overhead and justify market positions, this model has a tolerable risk profile in that a rent-to-own renter has more skin in the game than a traditional renter at the same time the builder has a clear exit strategy—the eventual sale of the home to said renter.

HOMEOWNERSHIP: DEAD OR DELAYED?

But with all this talk and little action to date of rental scenarios, it's up in the air whether traditional for-sale builders can get a rental operation up and running and contributing meaningfully to the balance sheet before the rental rage tempers.

“It's probably too late for home builders to do that anyway,” says Richard Gollis, principal at the Newport Beach, Calif.-based Concord Group, which advises both single- and multi-family developers and builders on land strategy and deals.

From the biases of his own perspective, Bozzuto's Baum sees the present moment as an extreme point of a swinging pendulum. “We definitely swung too far toward the homeownership side during the last decade, and now we've probably overcorrected to the extreme on the other end of the pendulum.”

Fundamentals, Baum notes, indicate that millennials have not abandoned the American dream of homeownership in droves. Bill Holford, president of California-based Olson Co., agrees. Holford's company specializes in high-density, affordable single-family home communities that often compete against apartment communities because of their locations and target buyers. Based on customer survey analysis, he estimates that 60 percent to 65 percent of his buyers are opting to purchase in an Olson community because they see paying rent as wasting money. Others are buying because of life changes like divorce.

“It depends on personal situation and certainly jobs,” Holford says of making the decision to buy a home or not. “Everyone goes through a rental phase, and whether it's now or five years from now, it's the great American dream that I own my own home.”

With dreams of homeownership looking more like they're just being put on hold rather than extinguished altogether, some industry stakeholders are content to just stick to their core business, focusing on the selling and building of single-family detached homes rather than getting sidetracked with a rental side business.

For one thing, it might not prove worth the effort over the longer term. “Folks in the industry have always been trying to make lemonade out of lemons,” says Tony Avila, CEO of Avila Advisors and a managing director of Encore Housing Opportunity Funds. “But I don't see [rental] as a recurring, steady-eddie business model.”

Don Tomnitz, president and CEO of D.R. Horton and unofficial king of the entry-level buyer market, is among those who are content to stick to home building despite the potential complement rental could provide to the company's first-time-buyer business. In a recent earnings call with analysts, he said, “There's one thing D.R. [Horton] and I are not confused about. We know we are a new-home builder. … And the ancillary businesses, we are going to leave to our competitors.”

No doubt the Beazer execs are thankful for that.

Rent vs. Own

A look at the math behind housing's biggest face-off.

Against rising rents, home builders in some markets have been pitting monthly mortgage costs against rental rates to show would-be buyers that it's more cost effective to own than rent despite uncertainty around home values. But that information, which had been used mostly as a marketing tool to sell new single-family homes, may very well be making a business case for builders to enter the single-family rental space.

Jonathan Smoke, senior vice president of products and innovation for Hanley Wood Market Intelligence, looked at 20 of the largest housing markets to see how the fair market rent for a three-bedroom rental stacked up against the monthly mortgage costs for a typical home, based on the NAR's June median home price results and August interest rates. In all but one market—the hyper-expensive metro New York region—it was significantly cheaper to own than rent.

Smoke says high rental rates in some markets reflect the limited stock of three-bedroom homes. “This hints at another valid point of the own-versus-rent debate: Is renting even an option for some households with larger space needs or more unique requirements, such as pets or in-law suites?”

Given the demand for alternative rental options and the fact that the bulk of single-family detached rentals are managed by mom-and-pop operations, Gadi Kaufman, managing director and CEO of real estate advisory firm RCLCO, believes these two trends add up to a scalable business. “I think there is a real business opportunity here, not just a salvation strategy for the builders,” he says.

NOTE: This analysis assumes that a median home has two to three bedrooms and calculates monthly mortgage payments based on a 20 percent down payment and interest rates as of Aug. 15. It also doesn't factor in the cost of property taxes or insurance or the benefits of mortgage interest deduction. It is only intended to illustrate the basic costs of homeownership against rental rates.

SOURCE: Hanley Wood Market Intelligence, NAR, Moody's Analytics, Nielsen